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"It appears to me that one great cause of our difference in opinion on the subjects which we have often discussed is that you have always in mind the immediate and temporary effects of particular changes, whereas I fix my whole attention on the long-term, permanent effects which result from them."

David Ricardo in a letter to Robert Malthus, 1817

HIGHLIGHTS

Again, as in early 1991, we hear the same siren calls for a U.S. recovery and a dollar bull market. It's the same old story fraught with the same fallacies. Markets so mobilized are bound to see painful disappointment.

We analyze all the major popular bull arguments for the recent dollar and market euphoria; they're all tenuous and fantastical. Generally speaking, we don't think that the recent scattered economic data deserves that much attention.

The great hope is that sharply lower interest rates will exert a stimulative effect on the housing and capital-spending sectors. Unfortunately, those sectors are more linked to long-term interest rates, not short-term rates. Long-term rates remain high, especially so, in real terms.

The recent surge of M1 growth, pointed to as a compelling sign of an imminent recovery, is a bubble heavily related to financial speculation. Rising demand deposits are being pumped directly back into higher stock and bond prices. It signifies nothing for the real economy.

It's most intriguing why the stock market should boom against a backdrop of record-low growth in broad money and credit.

Skyrocketing public borrowing requirements and the dearth of U.S. savings virtually dictates that long-term rates must go up. This year's $400 billion-budget deficit is bound to crush the stock and bond speculators, and with them, all hopes for recovery.

Export growth explains why the collapse in money and credit growth since 1988 didn't exert its normal contractive effects. Now that the world economy is weakening, exports too, are fading. That means that low money and credit growth will again determine the trend of the U.S. economy.

Barring a renewed export boom — something that's highly unlikely — we can't see anything that could drive a U.S. economic upturn. A U.S. recovery critically depends on a combination of income and credit expansion. The prospect for both of these strategic kingpins aren't hopeful.

Given the unprecedented heights of speculation, the prevailing complacency is simply unbelievable. While giddy psychology may rule for the moment, the message of long-run fundamentals is clear: a reckoning for the dollar, and the bond and stock markets.

DEJA VU: DASHING OPTIMISM BEFORE DASHED HOPES

Economic debate is as rudderless as the economy itself, to quote Robert L. Bartley, editor of the Wall Street Journal. At the same time, this is silly season for economic statistics owing to huge seasonal adjustments around the turn of the year. Meaningless wiggles in monthly economic data cause alternating gloom and euphoria in the markets.

Undaunted by last year's flop and false forecasts, market participants obviously want to repeat 1991's first half. The speculation is based on a familiar story: widespread belief in an imminent U.S. economic recovery and expectations of rising interest rates against a weakening European economy with falling interest rates. Presto, hot money is again flowing into the dollar.

Markets are driven by three different kinds of influences: 1. rumours, perceptions, expectations; 2. monetary conditions; and, 3. fundamental conditions.

Almost 60 years ago John Maynard Keynes lamented in his General Theory of Employment about the phoney "*expert professionals*" who mainly "*devote their intelligence to the anticipation of impending changes in the news or in the atmosphere by which experience shows that the mass psychology of the market is most influenced... In one of the greatest investment markets in the world, namely, New York, the influence of speculation (in the above sense) is enormous. Even outside the field of finance, Americans are apt to be unduly interested in discovering what average opinion believes average opinion to be; and this national weakness finds its nemesis in the stock market*".

As we have repeatedly stressed, financial speculation today makes the roaring 1920s look like a kindergarten party. What Keynes bewailed about Wall Street has long since found its nemesis in financial markets worldwide. Long-term investment is completely out of fashion. The chase for quick bucks and short-term trading are nowadays the dominating preoccupation. A feverish obsession to stay ahead of the game by discounting events far in the future, has turned the markets into a veritable fantasyland. Expectations, right or wrong, dominate over fundamentals . . . . at least for a time.

The essential result is unprecedented market volatility. Obviously, the trend towards computerizing information, decision-making and trading has greatly worsened this trend. Not only has technology sped everything up, what's worse, it's also contributed to the unifying and automatization of market opinion and market trends. That happens since traders and investors are guided by computer models that are based on very much the same assumptions and variables. Opinions mobilized so quickly and forcefully, inevitably, have a strong self-fulfilling, bandwagon effect. And once such a chain reaction develops, even the doubters have to jump on the trend since few can afford to stay aside.

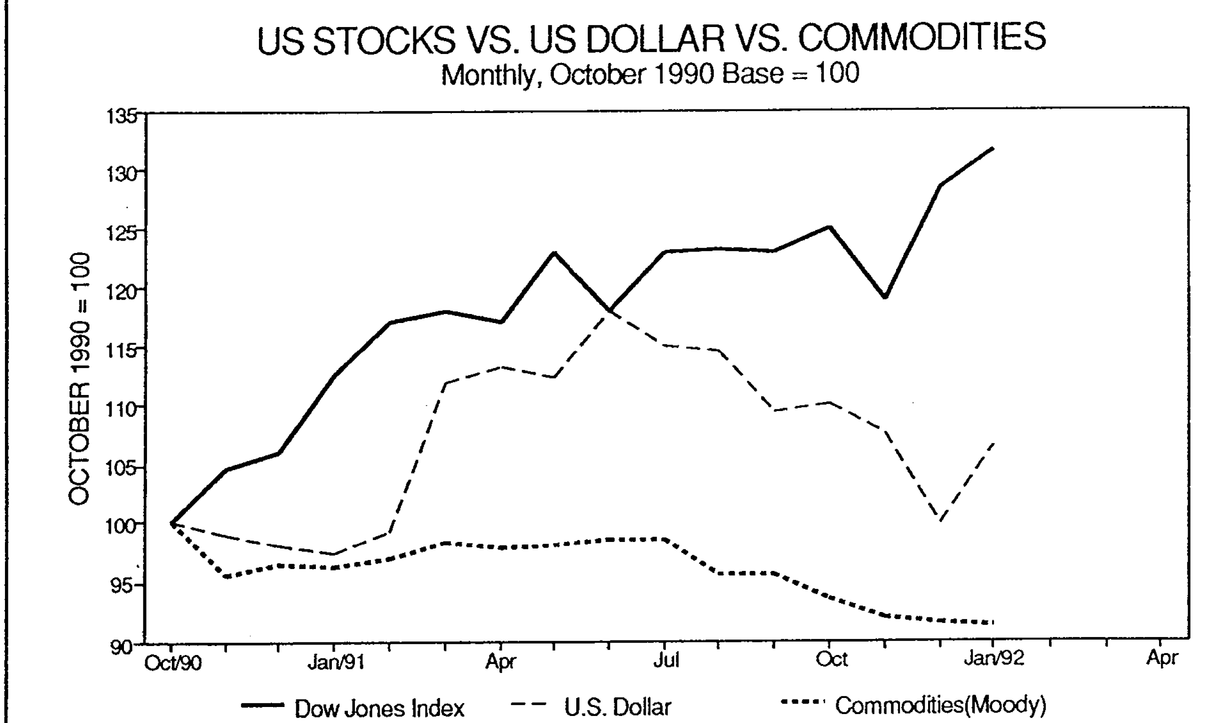
Observing this, Keynes commented: "*Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.*"

KEEP AN EYE ON FUNDAMENTALS NONETHELESS

Should we conclude that everything depends on the whims of market sentiment or the verdict of computer models and that the analysis of fundamental realities is totally useless nowadays? We pose these questions for a reason: the U.S. stock market's recent bullrun. What's driving it? What does the market see that we as individuals can't seem to fathom?

Knowing what we do about the U.S. stock market, we would never exclude the possibility of the upside charge continuing for a while. But we know — and so should everybody else — that we are witnessing a high-risk, speculative mania. In terms of value and underlying profits, stock prices are at insane levels never having been so high before except in Japan some years ago. Since then, however, Japanese stocks have fallen over 50%. Quarter after quarter, U.S. business profits disappoint expectations and forecasts, yet, stock prices go up and up.

Just take a look at the chart below illustrating the recent divergent developments between three major markets — U.S. stocks, the dollar and commodities prices (Moody-Index). All three of these series are indexed to a base of 100 for the month of October 1990. October was the month that the U.S. stock market began its recent bull run. Next to take flight on the wings of euphoric recovery forecasts was the dollar in February 1991. Interestingly, commodity markets were more down to earth and hardly moved.



Source: SMH-Research

October 1990, by the way, was also the month in which the Fed finally realized that the economy was weaker than expected and abruptly switched from a gradual to an aggressive monetary easing. Even though confidence and the currency continued to sink, the stock market took off.

PERCEPTION VERSUS REALITY

Following the victorious end of the Gulf War, it was the dollar's turn to stage a most spectacular rally. Between mid-February and early July it soared 28% against the D-mark, from DM 1.44 to DM 1.84. What actually spurred the U.S. currency to new heights was a rapidly spreading perception that rising consumer and business confidence would spark a robust revival of the U.S. economy in contrast to a concurrent economic slowdown in Germany and Europe. Together, this was supposed to lead to a narrowing — if not a reversal — of the existing interest rate differentials to the favour of the dollar.

All those bullish recovery and interest rate forecasts that drove the dollar up proved to be dead wrong. The European-American yield differentials, instead of sharply narrowing as predicted, widened dramatically to the favour of European currencies. Eventually, reality caught up with the dollar. As evidence mounted that the anticipated U.S. recovery was failing, the U.S. currency promptly retreated, shedding most of its previous gains. In the end, the true monetary and fundamental conditions took the upper hand. Still, false forecasts and expectations had swayed the currency markets for quite a while.

LISTENING TO WALL STREET OR MAIN STREET

Still, considering the endless stream of bad news about the U.S. economy, the U.S. dollar appears remarkably firm. It seems to us that this astonishing resilience, defying extremely negative monetary and fundamental conditions, has very much the same cause as the dazzling run-up of the U.S. stock market: an apparently unshakable optimism over the U.S. economy. It's false optimism in our view. But right or wrong, perceptions rule until something happens to destroy them.

But what about the gross contradiction between highly pessimistic consumer and business surveys and the bullish stock market? Main Street despairs and Wall Street rejoices; somebody must be terribly wrong.

What does the bullish stock market really reflect? Wall Street likes to peddle the idea that the stock market is an infallible signal of underlying optimism and an imminent recovery. This, indeed, has been the regular pattern in the past. A rising money supply, fuelled by a monetary easing, starts out impacting the financial markets and, with a lag of between two to six months, winds up in the real economy.

This time, the transitional phase from booming securities markets to the real economy's recovery drags on and on. It's now fully 32 months since the Fed started to ease. But all the Fed's easing since mid-1989 has failed to produce any visible result. Most ominously, it has even failed to boost money and credit growth, let alone the economy. Yet, stock prices are soaring, supposedly driven by a flood of liquidity. In reality, though, money and private credit growth are both at a record low.

That's the really intriguing part of the story; a booming stock market against a backdrop of record-low money and credit growth. Overall liquidity, as measured by M4, is rapidly contracting in real terms. Ironically, a sinking economy may be the greatest stimulant for financial speculation since it generates idle money. In the final analysis, money streams into financial speculation because the conduits into the real economy are clogged. What happens is that unattractively low interest rates for savings and the abysmal profitability of productive investment drives individuals and businesses into financial speculation.

All this reminds us of some remarks made by Joseph L. Schumpeter about the "*peculiarities of the pricing process on the stock exchange*". Essentially, he stressed two points: firstly, that there is much greater scope for irrational fancy and downright foolish hopes or fears in the stock exchanges than in ordinary business pursuits; and secondly, that considerable stock market booms can develop on a very narrow base of cash. He added: "*It is not easy to see how stock speculation could be starved by a lack of funds.*"

For Schumpeter, the 1929 scene differed little from the sham of the famous South Sea Bubble. Neither does the scene today. The only difference is that market valuations in terms of earnings are far more excessive today than those of 1929. It's important to shake off the infectious complacency on this point. While few have any sense of danger, the simple truth is that the culture of financial speculation today is many times more feverish than that of the infamous 1920s.

Considering the dismal U.S. economic situation over the last two, three years, the booming stock market is clearly a mockery of reality. Does its uptrend really reflect underlying optimism? Until recently, at least, the booming stock market has had more to do with individuals who are disappointed with the sharp fall in interest income and are consequently pouring money into stocks and mutual funds. This is hardly a sign of their optimism about the U.S. economy.

Wall Street and others, nevertheless, like to interpret any rise in stock prices as a sign of optimism and economic health. People of a more sceptical bent at least wonder whether such a boom would be possible if the economy truly were so seriously ill. What's definitely true is that the stock market's uptrend is a huge boost to psychology. Conversely, if the market should fall sharply, it would have a devastating effect.

A question we constantly pose is just what kind of catalyst would cause that to happen. A possible — if not probable — candidate is the overspeculated and highly vulnerable U.S. bond market.

FRENETIC BOND SPECULATION

While the stock market booms and titillates, making daily headlines in the papers, the most speculative, although less conspicuous, mania in the financial markets is the big money chasing around in the bond market. Banks, brokerage firms, bond funds, hedge funds, pension funds, insurance companies, corporations, and others have all joined in playing the anomaly of one the steepest U.S. yield curves in memory. It's become an enormous bet involving sums in the hundreds of billions of dollars, and including the derivatives markets, might even number in the thousands of billions of dollars.

This gigantic bond speculation is driven by two elemental forces: firstly, the record spreads between short and long-term interest rates; and secondly, expectations of huge capital gains on rising bond prices. The latter seems to be a safe bet as long as the Fed is committed to revving up a weak and sluggish economy at whatever the cost . . . especially so in an election year.

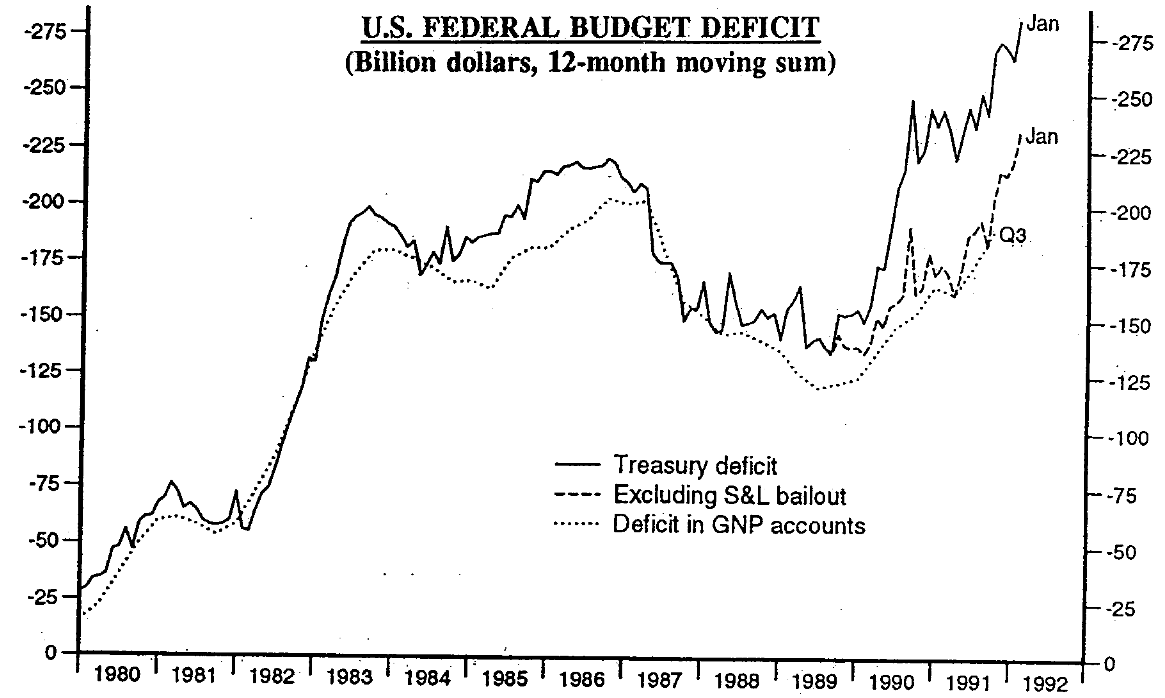
Unfortunately, Mr. Greenspan spoiled the party the other day when he opined in a Congress hearing that the Fed's easing to date might already be sufficient to kick-start a recovery for which he saw some "*stirrings*." Frightened speculators promptly dumped their bond holdings. As yields shot up across the board, all of the bond-price gains since the time of the Fed's last discount rate cut quickly vanished into the wind. GNMA yields, which are crucial to mortgage yields, have risen one full percentage point from 7.25% to 8.25%.

At the very least, this volatile tremor should serve as a warning of the extreme vulnerability of the over-speculated bond market. The point to see is why there's a record interest-rate spread to begin with and why there exists such a vulnerability. The reason for both is an underlying supply/demand condition in the bond market that's the most horrible in history. What's more, this imbalance continues to worsen despite a weak economy.

In the mid-1980s, the federal deficit amounted to around $150 billion. Last year, the deficit had already bulged as high as $269, billion outpacing available personal savings which only amounted to $222 billion. This year, the deficit is heading for a record-high of $400 billion and stands to be 200% of available personal savings.

This clash between skyrocketing public borrowing requirements and a dearth of savings means that rates can go up even if the economy goes down. We can't help but conclude that a $400 billion-budget deficit

is bound to crush the bond and stock market speculators and also any hopes for recovery.



Source: C.J. Lawrence, Weekly Economic Briefing, March 2, 1992

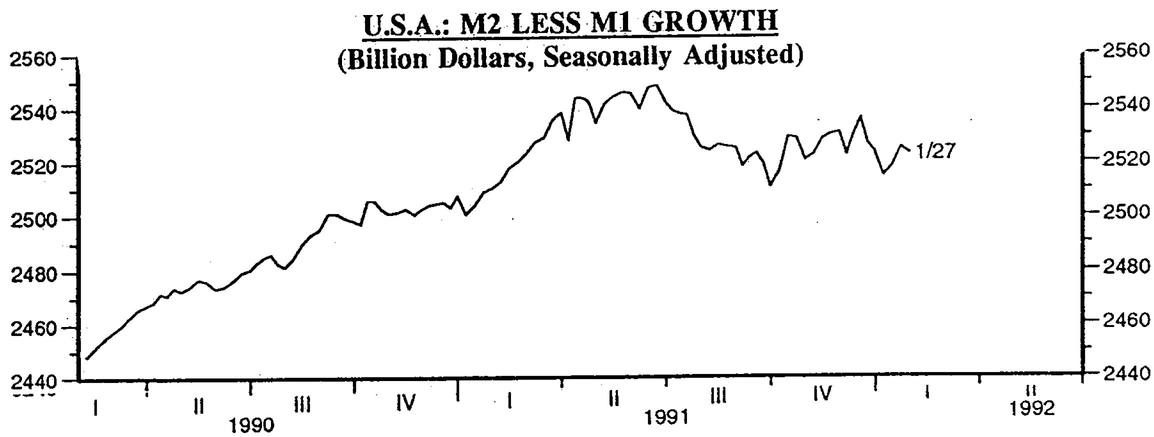
SIGNS OF RECOVERY?

Again, supposed signs of recovery are spooking the markets. What's the new evidence? Most often what's cited as the reliable signs of a recovering economy are recent rises in retail sales, housing starts and in the money supply.

Generally speaking, we don't think that such scattered data deserves all that much attention. More compelling to the bull case than just one month's seasonally-adjusted retail sales of 20 days' worth of car deals is the recent strong growth in money supply. M1 and bank reserves are soaring. What's being stressed above all, though, is that the growth this time is just not confined to narrow money, M1, but also to M2, the Fed's target.

The first thing to reflect upon is that around this time a year ago M2 also spurted, only to slump again later in the year. What makes the present sprint in M2 even more dubious is another point: namely that nearly all the gains in broad money have come from their M1 component which has been soaring at double-digit rates since last October.

Between the end of October and February 24 this year, M1 grew by $52.9 billion, M2 by $60 billion and M3 by a mere $33.6 billion. M4, the measure of overall liquidity, has only been reported to December 1991. For the whole of 1991, M4 only rose 0.7%. What's clear is that the only money category that's growing is M1; the others outside of M1 are still declining. (Please see chart on the opposite page)



Source: C.J. Lawrence, Weekly Economic Briefing, March 2, 1992

What's behind the surge in M1 and what is its significance? Does it mean a beginning recovery? As explained in the last letter, we suspect . . . no, we are sure that the M1 bubble is heavily related to the current rampant financial speculation. Rising demand deposits in the banking system are being pumped directly back into higher stock and bond prices.

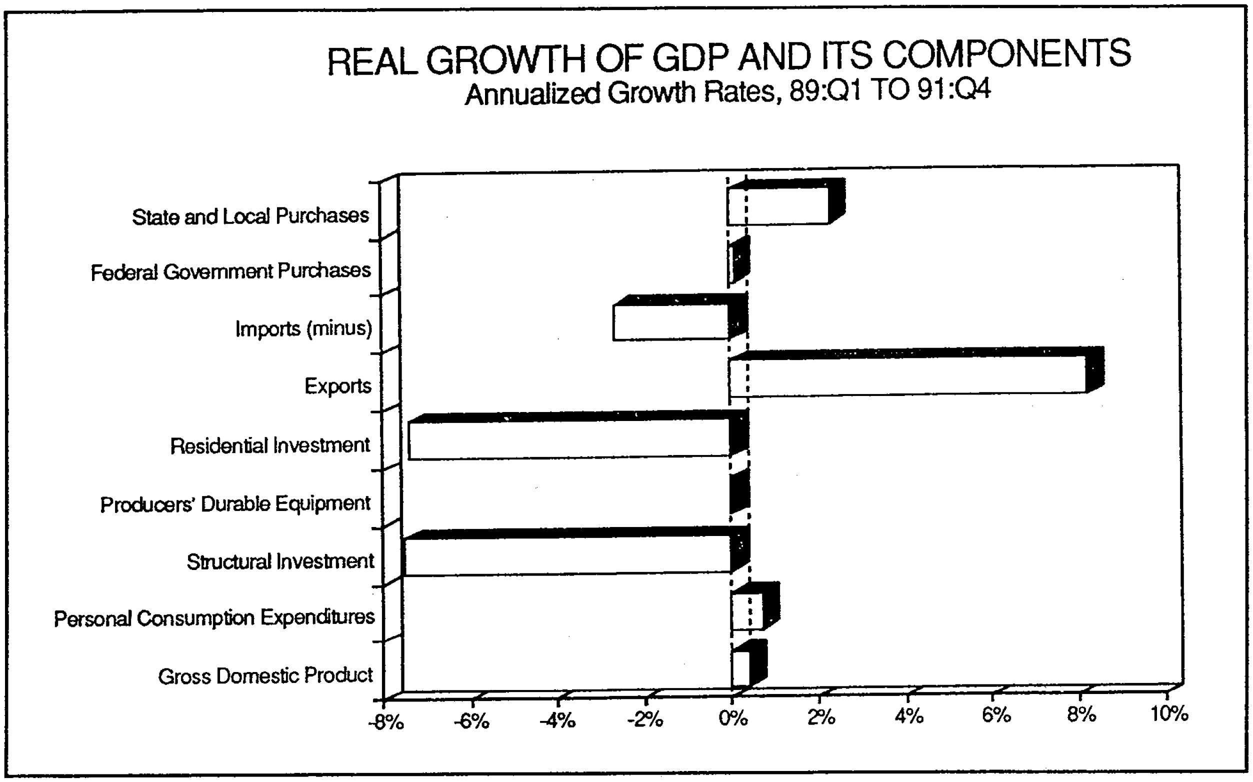
One look at the banking system's balance sheet dispels any doubt in our theory. We can be so sure because the banking system has only boosted its holding of government bonds (financial securities) while contracting its loans to consumers and businesses (who represent real private activity in the economy). During the six months between July 1991 and January 1992, commercial banks boosted their holdings of government bonds by a total of $50 billion while their loans to businesses and consumers contracted by $23 billion. Any money creation in this period, therefore, has corresponded to government borrowing.

A BLATANTLY INEFFECTIVE MONETARY POLICY

Apparently, it can't be stressed often enough: By far, this has been the longest period of monetary easing ever. But why? Is that a good or bad thing? No doubt, it's the latter because it reflects a glaring failure of monetary policy to move the real economy. Instead, all of its effects have been dissipated in rampant bond and stock speculation. It's remarkable how little attention is given to this failure of monetary policy.

The unpalatable truth is that this policy failure over this period is even greater than it seems. Domestic demand growth was even more pathetic than the headline GNP figures indicate. What largely masked that trend was a temporary U.S. export boom which was fuelled by the booming economies in the rest of the world. The chart on the next page shows this split performance. Real GDP grew at an annual rate of 0.4% from the first quarter of 1989 through the fourth quarter of 1991. That was equal to an increase of $66.5 billion in real terms. Real exports, though, alone rose $111 billion over this same period, meaning that the domestic components of the U.S. economy actually contracted by $44.5 billion.

Essentially, it's this strong export growth that also explains why the collapse in money and credit growth since 1988 didn't exert its normal contractive effects on the economy. But now, given the general weakening of the world economy, the export prop, too, is losing its thrust. Critically, domestic money and credit growth will again dominate the trend of the U.S. economy.



POWER TO THE CONSUMER

Given the persistent failure of monetary easing to stimulate private credit demand, many analysts have chosen to focus on the consumer's spending power instead. A popular view is that the savings generated by millions of homeowners refinancing their fixed-rate mortgages at cheaper rates or from the declining rates on adjustable-rate loans will flow directly into spending.

Obviously, any nonsense that seems to explain a possible recovery finds many ready believers. What really happens is a mere income redistribution from lenders to borrowers. There is no new income. The savings gain on the part of the borrower is the lender's income loss. Who are the creditors? That's the key question. Are they the banks, the money-market-funds? Of course not; they are only the intermediaries. The end-loser of the income decline is another consumer.

Yes, the argument goes, but the creditor who loses interest income tends to be better off and therefore has a lower spending propensity while the borrowing consumer who saves on interest costs has a higher propensity to spend. As a result, net spending should rise. Again, it's all fantasy. Risk-free investments such as savings deposits, CD's and money market funds, are typically held by the small saver, last but not least the retiree. According to the Fed statistics, only about 20% of all savings and time deposits are in accounts greater than $100,000. Therefore, we fully agree with Albert Sindlinger who says that the income losses from falling interest rates are greater than the gains that accrue from the mortgage refinancings.

THE TWO STRATEGIC FACTORS

Barring an improbable export boom, a sustained, cumulative U.S. recovery critically depends on a

combination of income and credit expansion. These are the two strategic factors to keep an eye on. What do they hold in store?

Consumer income growth is at a postwar record-low. Between 1982 and 1990, personal income increased at an average annual rate of 7.3% before adjustment for inflation. During the last two years, income growth slumped to 2.8%, barely the inflation rate. Real disposable income has been virtually flat for fully two years.

Given that the savings rate is still at near-record lows, it's obvious that the prospect of increased spending is confined to the very narrow limit of current income growth. Therefore, to start a recovery, higher consumer spending requires heavy new borrowing. So far that's not happening . . . and it probably won't for yet another important reason.

While many fear for their job, even more consumers fear for the value of their homes. Generally, home equity represents the major part of most peoples' wealth. Leaving aside the question of whether sharply higher consumer borrowing is really desirable from a long-term perspective, the fact is that neither income growth nor asset values nor credit trends support the conclusion that consumer spending might lead a recovery. Any changes in underlying conditions are rather likely to be worse.

The great hope is that sharply lower interest rates will exert a stimulative effect on the housing and capital-spending sectors. Unfortunately, those sectors are more linked to long-term interest rates, not short-term rates. As we've already mentioned, the problem is that long-term rates have been sticky and have not declined significantly. In fact, they have been rising in real terms. Above all, long-term interest rates remain extraordinarily high compared with the poor business-profit picture and the depression in real estate.

If the consumer is unable to lead a recovery, then what about investment? Fixed investment is a small share of U.S. GNP. Therefore, what's needed to set off a cumulative recovery is a roaring investment boom. In 1982-83, for example, residential building started recovering at annual growth rates of 45%, 71%, 66% and 40% respectively in each of the first four quarters. Given the sticky long-term rates, such zip is virtually impossible this time.

MILD RECOVERY: A FALSE HOPE

Since a normal-variety, robust recovery remains clearly out of question, Wall Street has quickly fallen in love with the idea of a "*mild recovery*". It conjures up the notion of permanently low inflation and low interest rates thus helping to stoke up the fire of financial speculation.

According to the consensus forecast, real U.S. GDP is supposed to grow only 2.3% from the fourth quarter of 1991 to the fourth quarter of 1992. That's less than half the average 6% growth rate of the first year of all post-war economic recoveries.

Such a weak economic recovery has never happened before, nor will it happen in the future. Why? Because it simply can't work. Economic growth is always at its fastest at the beginning of a recovery. That's not a policy mistake but a necessity. To lift a plane into the air, what's initially required is a high speed. The same is true for a cyclical recovery. A "*mild recovery*" at the rate of 2.3% is certainly insufficient to create the spontaneous combustion necessary to trigger sustained growth.

There is a widespread view that the recovery ought to be weak just because the recession was mild. It's

reasoned that since growth didn't fall much, it therefore can't rise much. Even that is a delusion. All post-war recessions have been preceded by a boom and lasted no longer than eleven months on average. This recession, by contrast, has started in the midst of a three-year period of near-stagnation (or "*growth recession*") unprecedented in the post-war era.

To understand the true depth of this U.S. recession, we have to measure the shortfall of real GNP growth against its average or potential growth. By this yardstick, the current U.S. recession already qualifies as one of the three worst since 1948 according to a study recently published by the Federal Reserve Bank of Minneapolis. In fact, it's the U.S. economy's longest slowdown — now entering its 12th quarter — since the end of World War II. No other slowdown has lasted more than seven quarters.

We would add that not only is this already the worst slowdown in terms of duration, it's equally the worst in terms of such worldly things as personal, business and bank bankruptcies, a credit crunch, income growth, a profit squeeze, capital losses in real estate, and last but not least, in terms of the budget deficit. We thoroughly pooh-pooh the notion of a "*mild recession*" and so do most consumers and business people. And let's not forget that this period of three years over which all of the above-mentioned hardships have cumulated has ominously been a period of a persistent, progressive monetary easing.

WHENCE SHOULD HELP COME?

Earlier we said that the main prop of the U.S. economy over the recent years has been exports. If it had not been for the temporary demand boom in the rest of the world, America would long be in a near-depression. Let's take a more detailed look at the extremely diverse developments of foreign demand and the various domestic demand components.

The main point of the adjacent table is that U.S. domestic demand has only grown a mere 4.5% in the four years since 1987. Virtually all of that growth occurred in 1988.

QUANTITY INDICES FOR U.S. REAL GDP
Cumulative % Change from Q4 1986 to Q3 1991

Personal Consumption Expenditures		
Durable Goods	+	3.6
Nondurable Goods	+	3.7
Services	+	10.2
Fixed Investment		
Structures	-	13.2
Producers' Durable Equipment	+	10.7
Residential	-	21.4
Exports of Goods and Services	+	49.5
Imports of Goods and Services	+	13.7
Government Spending	+	6.1
State and Local	+	11.0
Gross Domestic Spending	+	4.5
Gross Domestic Product	+	7.1

What's wrong with an export boom? Nothing. Quite to the contrary, the U.S. economy's transition towards export-led growth during 1988-89 was exactly the kind of internal and external adjustment that America needed as an antidote for its huge trade deficits. It has proved to be a saving grace for both the stock market and the dollar.

All the same, it's time to do some thinking about two questions that are of crucial importance to the dollar's long-term outlook: the duration of the export boom, and secondly, its causes.

As to the first question of the duration of the export boom, there is probably little disagreement. Given spreading economic weakness in the rest of the world, the export boom is certain to peter out. U.S. goods exports already declined in November and December of last year — down 0.5% and 2.2%, respectively — and are likely to trend flat or down in 1992.

The second important question concerning the causes of the export boom has never been seriously debated. In general, most observers attribute the boom to a "cheap" dollar defined in terms of the purchasing power parity theory (PPP) and international competitiveness. The same argument has also been the recurring touchstone for the dollar's bull case.

No doubt, the above explanation for the export boom has the great advantage of simplicity and plausibility. In economics, though, usually that kind of answer is wrong. The prevailing view that changes in trade balances are mainly determined by relative price changes (mainly currency movements) really belongs to the most primitive and antiquated of concepts of international trade theory. Already no later than the 1920s it was realized and generally accepted that changes in the trade balance were mainly a function of demand effects, not price effects. In today's popular vernacular we would say that it's the economic growth differentials between regions or countries that are the main dynamic behind trade performances.

NO SIGN OF IMPROVED COMPETITIVENESS

Actually, the growth gap between America and the rest of the world since 1987 is mind-boggling. While U.S. domestic demand growth totalled an anaemic 4.5% in this period, it was 16% in the rest of the OECD-countries (Organization for Economic Cooperation and Development) not including the recent booms in Latin America.

Such a tremendous growth gap easily explains most if not all of the reduction in the U.S. trade deficit from $159 billion in 1987 to around $60-70 billion presently. There's other evidence, too, that supports that conclusion.

U.S. merchandise exports rose an impressive 74% in the 1980s. In reality, though, that's really a mediocre performance compared with total world trade which grew by approximately the same rate. It tells us that U.S. exports barely held their share of world markets. Another trend to take note of is that U.S merchandise imports rose by 13.7% since 1987, far outstripping domestic growth of an anaemic 4.5%.

Though imports have slowed down sharply from their high pace of the mid-1980s, they've still been growing far faster than domestic demand. That's hard evidence in itself that the U.S export boom has had little to do with increased competitiveness. If that were not so, imports would more likely have fallen relative to domestic demand growth. As it is, the share of domestic spending for imported goods other than petroleum has continued to rise, hitting a new record-high of 21.9% in the fourth quarter of 1991.

These few facts show just how hollow all that PPP talk really is. It's definitely a sign of lacking international competitiveness if a country runs a large external deficit — large by traditional standards — in the depths of a recession. Any economic recovery, essentially, would quickly boost imports.

So much for the "PPP" theory. We shall come back to it in a future letter. It's a broad and fascinating topic. Just one short observation: If you want to cut through all the smoke and mirrors of international competitiveness, look at the relative investment and profit ratios. Dollar bulls who tell us that the U.S. dollar is grossly undervalued have yet to explain why U.S. manufacturing industry is in the grips of a secular profit squeeze and shrinking instead of investing and flooding world markets with its "cheap" products.

CONCLUSIONS

Just like last year, markets are betting on a surefire U.S. economic recovery. And so, hot money is again flowing into the dollar though all the fundamentals — incomes, profits and credit — remain decisively negative. But, right or wrong, perception rules in the short run: reality rules over the long run. Expectations are overblown and therefore stand to be deflated again.

Given the intensity of the speculation on an imminent cyclical U.S. recovery, we have devoted most of this letter to this short-term question. Any disappointment could easily crack the still widespread complacency and shatter the markets with a vengeance.

As we've shown, any short-term revival of the U.S. economy will be paltry at best. What should be of far more greater importance for investors is the fact that the 1990s will be the slowest growth decade in history for the U.S. economy due to its many structural problems. That means that U.S. interest rates must remain at low, internationally unattractive levels for a lengthy period of time.

At the root is America's declining capability to generate long-term growth and rising incomes. Its record of productivity gains since the early 1970s is the poorest of the industrial countries except England. Annual productivity growth averaged 2.4% in the 1960s, 1.3% in the 1970s and 0.8% in the 1980s. At the same time, labour growth has slowed sharply for demographic reasons.

This deterioration coincides with an enhanced growth outlook for Europe, and Germany in particular. For example, the IMF (International Monetary Fund) recently projected West Germany's potential growth to increase to 3% from a 2.2% level earlier in the 1980s owing largely to higher investment and stronger labour growth. As a result, the German economy is able to bear much higher interest rates on a secular basis than can the U.S economy.

The sharp divergence in economic growth between America and Germany is far more than simply a cyclical symptom. All this heralds deeper secular changes in the growth potential of both countries.

In the next letter, we shall address the more important question of longer-term growth prospects which will crucially determine the DM/$ rate into the mid-1990s and later.

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